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No. .....
IN THE

Supreme Court of the United States

October Term, 1980

LOYD S. DRENNAN,

Petitioner,

vs.

SECURITY PACIFIC NATIONAL BANK,

Respondent.

Petition for Writ of Certiorari to the Supreme Court for the State of California.

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To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Loyd S. Drennan, the petitioner herein, prays that a Writ of Certiorari issue to review the judgment of the Supreme Court of California entered in the above-entitled case on January 22, 1981.

Questions Presented.

1. Did 15 U.S.C. §1610, *et seq.*, (The Truth in Lending Act) and 12 C.F.R. §226, *et seq.*, (Regulation Z) preempt application of state common law requiring additional but not contradictory disclosure of consumer credit contract terms?

2. Did the California Supreme Court err in failing to comply with the administrative procedure established by 12 C.F.R. §226, *et seq.*?

3. Would the California Supreme Court opinion require an interpretation of the Truth in Lending Act and Regulation Z which is violative of the 5th and 14th Amendment of the Constitution of the United States?

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LOYD S. DRENNAN,

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vs.

SECURITY PACIFIC NATIONAL BANK,

Respondent.

Petition for Writ of Certiorari to the Supreme Court for the State of California.

Opinions Below.

The Opinion of the California Supreme Court dated January 22, 1981, is reported at 28 Cal.3d 764 and is printed in Appendix "A" hereto.

Jurisdiction.

The judgment of said Court was entered on January 22, 1981. The jurisdiction of the Supreme Court is invoked pursuant to 28 U.S.C. §1257(c) which provides:

> "By writ of certiorari, where the validity of a treaty or statute of the United States is drawn in question or where the validity of a State statute is drawn in question on the ground of its being repugnant to the Constitution, treaties or laws of the United States, or where any title, right, privilege or immunity is specially set up or

claimed under the Constitution, treaties or statutes of, or commission held or authority exercised under, the United States."

Statute and Regulations Involved.

Section 1610 of the Truth in Lending Act (15 U.S.C. §1610) states:

"(a) this subchapter does not annul, alter, or affect, or exempt any creditor from complying with, the laws of any State relating to the disclosure of information in connection with credit transactions, except to the extent that those laws are inconsistent with the provisions of this subchapter or regulations thereunder, and then only to the extent of the inconsistency.

***

(d) Except as specified in sections 1635 and 1640 of this title, this subchapter and the regulations issued thereunder do not affect the validity or enforceability of any contract or obligation under State or Federal law."

12 C.F.R. §226.6(b) (a regulation promulgated under the authority of the Truth in Lending Act by the Federal Reserve Board known as Regulation Z) provides:

"(b) Inconsistent State requirements. With respect to disclosures required by this part, State law is inconsistent with the requirements of the Act [section 1601 *et seq.* of this title] and this part, within the meaning of section 111(a) of the Act [section 1610(a) of this title], to the extent that it:

(1) Requires a creditor to make disclosures different from the requirements of this part with respect to form, content, terminology, or time of delivery;

(2) Requires disclosure of the amount of the finance charge determined in any manner other than that prescribed in §226.4; or

(3) Requires disclosure of the annual percentage rate of the finance charge determined in any manner other than that prescribed in §226.5."

12 C.F.R. §226.28(a) provides in pertinent part:

"(a) *Inconsistent disclosure requirements.*

(1) State law requirements that are inconsistent with the requirements contained in chapter 1 (General provisions), chapter 2 (Credit transactions), or chapter 3 (Credit advertising) of the act and the implementing provisions of this regulation are preempted to the extent of the inconsistency. A state law is inconsistent if it requires a creditor to make disclosures or take actions that contradict the requirements of the federal law. A state law is contradictory if it requires the use of the same term to represent a different amount or a different meaning than the federal law, or if it requires the use of a term different from that required in the federal law to describe the same item. A creditor, state, or other interested party may request the Board to determine whether a state law requirement is inconsistent. After the Board determines that a state law is inconsistent, a creditor may not make disclosures using the inconsistent term or form."

Statement of the Case.

On June 5, 1974, petitioner, LOYD S. DRENNAN, purchased a mobilehome in San Luis Obispo County, California, for $25,964.00. The purchase was financed through the respondent, SECURITY PACIFIC NATIONAL BANK, hereinafter referred to as "SECURITY PACIFIC", and entered into a finance agreement by executing SECURITY PACIFIC'S standard form written contract and security agreement. The contract was executed by the mobilehome seller and was immediately assigned to SECURITY PACIFIC.

Pursuant to this agreement, LOYD DRENNAN borrowed $21,721.00 to be repaid in 180 equal installments of $277.56 each, which sum included an interest payment at the rate of 12.98% per annum. The contract called for a total finance charge of $27,797.60 to be paid over the anticipated 15-year term of the loan. The agreement entitled "Conditional Sale Contract — Mobile Home, Recreational Vehicle" contained the following provision:

> "*Prepayment.* In the event buyer prepays the indebtedness hereunder in full prior to maturity, buyer is entitled to a refund of the unearned portion of the finance charge computed in accordance with the 'Rule of 78's' except that no refund of less than $1.00 shall be made."

This method of disclosure was adequate by virtue of the Truth in Lending Act pursuant to 12 C.F.R. §226.8(b)(7) (printed herein for convenience in Appendix "B" and California Consumer Credit Disclosure Statutes which incorporated by reference 12 C.F.R. §226.8(b)(7) (California Civil Code §2981, *et seq.*).

In May of 1977 the petitioner, upon deciding to sell his mobilehome, contacted SECURITY PACIFIC as to the exact amount required to pay off the loan in full. He was advised by letter on May 18, 1977, that the amount required to repay the loan in full was $22,306.79 as of said date. Thus, after making payments for almost three years totaling $9,714.60, petitioner was informed that the payoff on his loan of $21,721.00 was $22,306.79.

At page 3, line 1, of his Complaint, petitioner alleged that the "prepayment" clause is vague, ambiguous and uncertain in that it failed to advise petitioner that a prepayment penalty will be charged in the event of prepayment and to explain or define the "Rule of 78's" and what amount, if any, will be charged in the event of prepayment.

Petitioner's Complaint did not attack the legality of the use of the "Rule of 78's" method. The use of the Rule was expressly approved by Federal and State statute. Petitioner did not claim any violation of the Truth in Lending Act or any State Consumer Credit Enactment.

Petitioner's Complaint was based solely on the alleged violation of fundamental common law contract doctrine developed by the State Common Law in California known as the Adhesion Contract Doctrine. At its essence, petitioner's Complaint alleged that there was no meeting of the minds under the language and circumstances of the contract which would allow the bank to enforce its unexpressed intention to exact a penalty charge in the event of prepayment. The respondent bank demurred.

After the trial court sustained respondent's demurrer without leave to amend, petitioner's appeal ensued to conclusion in the California Supreme Court.

Reasons for Granting the Writ.

There now exist in the United States millions of installment sale contracts which have been executed under the ambit of the Truth in Lending Act.

It was the object of the Act to "assure meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit". (15 U.S.C. §1601.)

This same Act is being used by the respondent bank and hundreds of others to prevent meaningful disclosure of credit terms and to mandate the uninformed use of credit.

As Congress retreats from the scant protections provided by the Act under the guise of deregulation (12 U.S.C. §3501, *et seq.*) the consumer must rely upon the protection

of state law afforded by stricter and more effective disclosure requirements.

The California Supreme Court has decided on the basis of an unofficial staff opinion letter that it is precluded and preempted by the Truth in Lending Act and Regulation Z from applying state common law which would prevent the enforcement of contract provisions where there has not been sufficient disclosure to create a contract.

The unofficial staff letter and the court's opinion based upon it were flatly contrary to the official Federal Reserve Board interpretation which was issued subsequent to the court's ruling. The Board has determined that state disclosure requirements which are more strict than those provided by the Truth in Lending Act and Regulation Z are nonetheless viable and not preempted unless such requirements "contradict" the federal disclosures. In so doing, the Board announced its interpretation of Congress' intent as originally expressed in the Act.

In the Drennan opinion, the California Court has created a rule of federal preemption which is contrary to the interpretation of the Board. It creates a rule which exists only in California and is out of step with the federal scheme of consumer credit regulation in both substance and procedure.

ARGUMENT.

I.

The Truth in Lending Act and Regulation Z Do Not Preempt Stricter State Disclosure Requirements.

At the heart of petitioner's cause of action is the fact that the contract provision complained of and set forth hereinabove fails to give even the vaguest hint of the real economic consequences of prepayment.

It must be noted that the provision speaks of a "refund". It says nothing about a charge or penalty.

The California Supreme Court in the instant case, concluded that the provision amounts to a hidden charge or penalty: "In sum the 'Rule of 78's' is a hidden charge, the operation of which is neither revealed to nor understood by the borrower, and it is a charge burdensome to the consumer and unjustified by the economic needs of the lender."

The court observed that this unpleasant surprise results in the exaction of an estimated $112 million dollars, a year in overcharges by banks.

This prepayment charge can distort the annual percentage rate by more than three percent.

The Federal Reserve Board and the courts have examined the ambiguity of provisions like that in Mr. Drennan's contract and the unfair result it creates. These decisions have invariably involved action based upon the validity of contracts pursuant to the Truth in Lending Act or Federal Reserve Board Regulations.

The Federal Reserve Board issued a regulation cited at 12 C.F.R. §226.8(b)(7) and printed herein as Appendix "B" which allows the mere reference to the "Rule of 78's" as a sufficient disclosure of the method of calculating the prepayment rebate, without requiring as a requisite of the

Truth in Lending Act or Regulation Z a definition, explanation, example or warning of how the Rule of 78's worked or what its consequences were.

In *Bone v. Hibernia Bank* (9th Cir. 1974) 493 F.2d 135, the court of appeal upheld the discretion of the Board but stated:

> " 'Identification' could mean, as the district court held, that the method of rebating unearned interest must be one which is understood by the average borrower, in order that it in fact be 'identified'. Simple reference to the Rule of 78's does not serve this function, for we daresay that its meaning is known to virtually no credit consumers. As the district court stated, 'There must be a recognized nexus between the words used and some acceptable referent, or else the words used are at large and divorced from both reality and meaning'."

Upon review of petitioner's appeal, the California Supreme Court concluded that it was preempted by 15 U.S.C. §1610 and 12 C.F.R. §226.6(b) from applying the state common law doctrine of Adhesion Contract. This judicially developed doctrine of fundamental contract law would have prevented the bank from enforcing the provision complained of. The ambiguity inherent in the provision of the contract, executed in circumstance of disparate bargaining power between the consumer and the bank, prevented a meeting of minds.

The issue rested upon the court's interpretation of the meaning of the term inconsistent as used in 15 U.S.C. §1610.

While the issue was the subject of intense briefing and argument, it was essentially a matter of first impression since no official Federal Reserve Board interpretation or court ruling had issued on the subject.

Petitioner relied upon *Mason v. Gen. Finance* (4th Cir. 1976) 542 F.2d 1226, 1234, which determined:

> "The congress clearly did not preempt the field. Not only is the substantive law of the state preserved in tact as to the rates of charges but even disclosure of information in connection with credit transactions required by state law is specifically protected by the federal statute, except to the extent that those laws are inconsistent with the provisions (of the Consumer Credit Protection Act) or regulations thereunder and then only to the extent of the inconsistency." (15 U.S.C. §1610(a).) "It is our federalism and congressional respect for it that occasions the difficulty in this case. Our problem then is how to accord supremacy to federal law and at the same time honor the provisions of state law in accordance with the congressional directive".

Respondents relied upon an unofficial staff interpretive letter which was submitted to court by letter dated October 2, 1980.

The letter expressed a belief by one staff member that a state requirement that the bank define, explain, or warn of the consequences of prepayment provisions would probably be preempted. Respondents asked that this unofficial interpretation be given the deference of a staff interpretation of the Federal Reserve Board issued pursuant to its interpretive responsibility under 12 C.F.R. §226.1(d). The court, citing *Ford Motor Credit Company v. Milhollin* (1980) 100 S.Ct. 790, expressly relied upon this unofficial letter in its opinion.

If it were not clear from the face of 15 U.S.C. §1610 and 12 C.F.R. §226.6(b) that stricter state disclosure requirements were not preempted unless they "contradicted" federal disclosures, the Federal Reserve Board issued an official interpretive regulation at 12 C.F.R. §226.28 which makes this proposition irrefutable and the California

Supreme Court's opinion herein irreconcilable with the Truth-in-Lending Act.

As this court has so often stated, the interpretation of the Federal Reserve Board should be given great weight when it interprets a Congressional directive, and in particular the Truth in Lending Act.

The ruling of the California Supreme Court has created a rule which is followed nowhere else in the Union. It is inconsistent and irreconcilable with the federal-state consumer credit scheme. It has abdicated power to the federal government where none was sought.

II.

The California Supreme Court Failed to Comply With Federal Administrative Procedure.

15 U.S.C. §1610 and §1633 and 12 C.F.R. §226.6 establish a procedure whereby the Federal Reserve Board is given the power and procedure to determine whether there is an inconsistency between a state disclosure requirement and the Truth in Lending Act. Further, the Board is empowered to grant by regulation an exemption to a state from complying with the provisions of the Act.

Such determinations are to be made by the Board pursuant to the procedure established by the Board's Rules of Procedure (12 C.F.R. §262) and the Federal Administrative Procedure Act.

This procedural scheme affords petitioner all of the protections afforded by the Acts, including the right to notice, the right to be heard, rights to access to records and other essential rights.

The procedural scheme also assures that interpretations of the Truth in Lending Act and the application of its provisions are consistent and uniform within the framework of the federal-state constitutional structure.

The California Supreme Court's precipitous action in preempting itself cut off petitioner's vital procedural rights. Without an announcement of the California common law requirement, neither petitioner, respondent nor any interested party can seek the interpretation of the Federal Reserve Board.

Should this Honorable Court reverse the judgment of the California court, petitioner will be entitled to a decision on the merits of his contention that state common law affords him protection from the hidden charge imposed by the subject prepayment provision. The Supreme Court of California refused to decide the issue by stating:

> "Whether or not the use of a term which the drafter of the contract knows to be intelligible to the weaker party invokes the law relating to adhesion contracts we need not reach because we conclude this court is prohibited by federal law from requiring that a lender explain the meaning of the words in question." (*Drennan, supra*, at 770.)

We request that this Honorable Court direct the California court to answer the question under state law and allow for the operation of the federal administrative procedure.

III.

The California Supreme Court's Decision Would Require an Interpretation of the Truth in Lending Act Which Would Violate the 5th Amendment.

If state common law, which would provide a definition, explanation or warning of the consequences of the subject contract provision were precluded by the Truth in Lending Act then a contract provision such as the one in Mr. Drennan's contract which contains no definition, explanation or warning of the consequences of the prepayment provision would be approved, if not mandated, by federal law.

In fact, in the instant case respondents have argued that federal law mandates the disclosure of the prepayment "rebate" in the manner done so in respondent's contract.

If state law requirements were not allowed to intercede and provide the consumer with the information needed he would have no notice of the intention of the bank to take a "hidden charge or penalty" in the event of prepayment.

Such a private action to collect such a hidden charge under the authority of the federal regulation and by virtue of the enforcement of such a contract right in the courts of the United States or a state would constitute a deprivation of property without due process of law in violation of the 5th Amendment.

Conclusion.

The California Supreme Court has been misled by respondents to believe that the Federal Reserve Board has interpreted the Truth in Lending Act to preempt any disclosure other than those required by Regulation Z. The Federal Reserve Board has made clear the congressional intention originally expressed in the Act.

The decision of the California Supreme Court cannot be reconciled with the Board's regulation and the court must act to establish a uniform rule on the substantive and procedural issues raised herein.

The Banks cannot be allowed to use the Truth in Lending Act which was intended at its inception to protect the consumer and provide him with information to preclude the application of state law which would operate to accomplish this same end.

Respectfully submitted,

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APPENDIX A.

In the Supreme Court of the State of California.

Loyd S. Drennan, Plaintiff and Appellant v. Security Pacific National Bank, Defendant and Respondent. L.A. 31247, Super. Ct. No. 49108.

Plaintiff, Loyd S. Drennan, purchased a mobile home financed by defendant Security Pacific National Bank (defendant) under a conditional sale contract. The contract provided that if plaintiff repaid the indebtedness prior to maturity, he was entitled to a refund of the unearned portion of the finance charge in accordance with the "Rule of 78's." Plaintiff claims that the contract was an adhesion contract, that the term "Rule of 78's" is ambiguous, and that the prepayment provision is void.

The primary question before us is whether federal law precludes us from requiring that conditional sale contracts provide a definition of that term. As will appear, we answer this question in the affirmative and conclude, in addition, that while a statement in or appended to the contract to alert the borrower that the rule may operate to his disadvantage may be desirable and consistent with federal law, the law governing adhesion contracts does not compel such a warning.

Plaintiff purchased a mobile home on June 5, 1964, at which time he entered into a conditional sale contract with the seller. He financed $21,965 of the purchase price; the finance charge, $27,997.60, was computed at the time the contract was signed, so that the total amount he would be required to pay by the end of the term of the contract was $49,962.60. The contract called for him to pay that sum in 180 monthly installments of $244 each, including interest on the unpaid balance at the rate of 12.98% a year. A clause of the agreement provided that if plaintiff prepaid the in-

debtedness in full prior to maturity, he would be entitled to a refund of the unearned portion of the finance charges "computed in accordance with the 'Rule of 78's'. . . ." The contract was assigned by the seller to defendant.

After making the installment payments called for in the contract for almost three years, plaintiff proposed to sell the mobile home. Defendant notified him that the amount required to pay off the loan was $22,306.79, or $341.79 more than he had originally borrowed, although he had paid more than $9,700 in installment payments in the interim.

Plaintiff filed a complaint for declaratory relief on behalf of himself and others similarly situated, alleging that the contract was an adhesion contract and that the provision regarding prepayment quoted above is vague, ambiguous, and uncertain because it failed to explain or define the term "Rule of 78's" and did not advise him that a "prepayment penalty" would be charged, and the amount thereof. He sought a declaration that the provision was void and unenforceable, and prayed for damages in the amount of the "prepayment penalty" on behalf of the members of the class. The trial court sustained defendant's demurrer without leave to amend, and dismissed the action. Plaintiff appeals from the ensuing judgment.

The operation of the "Rule of 78's" has been explained in a variety of ways; two of these explanations are set forth in the margin.[1] For the purposes of this opinion, it is suf-

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[1]The Civil Code describes the rebate due under the rule by specifying that the "amount of the unearned portion of the finance charge shall be at least as great a proportion of the finance charge . . . as the sum of the periodic monthly time balances payable more than 15 days after the date of prepayment bears to the sum of all the periodic monthly time balances due under the schedule of installments in the contract. . . ." (Civ. Code, § 2982, subd. (e)(1).)

The Commerce Clearing House Consumer Credit Guide employs the following explanation of the operation of the rule:

ficient to observe that under this method of calculating the rebate to a borrower upon repayment of a loan prior to maturity[2] he receives a smaller refund than he would be entitled to if the interest was calculated strictly on the basis of the time he had use of the money. For example, if the prepayment occurs one-third of the way through the term of the loan, the lender retains not one-third of the interest but over 46%. If the refund due the borrower is determined by the actuarial method, which measures the true interest yield, the amount of interest charged would bear a direct relationship to the amount of money used by the borrower and the period during which he had retained it, and the refund would be larger than under the "Rule of 78's." Although the difference between the two methods is insig-

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"In the case of advance payments, many creditors will rebate an unearned finance charge in accordance with the Rule of 78's, also referred to as the sum-of-the-digits method, which works in the following manner:

"On a 12-month repayment plan, the numbers 1 through 12 are added together to provide the figure 78. This becomes a denominator in the calculation. The sum of the months expired at the time of prepayment becomes the numerator. The resulting fraction represents the earned finance charge.

"The first month of a 12-month obligation is considered as 12 because the outstanding balance is 12 times as large during the first month as it is for the last month. The second month is 11, and so an until 1 designates the final month.

"Thus, the portion of the finance charge considered earned after the first month is 12/78 of the entire finance charge. For the second month alone it is 11/78. If prepayment occurs at the end of the second month, the earned finance charge is 23/78 of the total finance charge — 12/78 plus 11/78.

"If prepayment occurs after the 8th month, the amount of earned finance charge will be 68/78 (the sum of 12/78, 11/78 . . . 5/78). Put another way, the rebate will amount to 10/78 of the total finance charge, less any charges that might be deducted from that amount." (CCH Cons. Cred. Guide, Truth-in-Lending, ¶ 1452.)

[2]While we recognize that a conditional sale contract is not a loan and that the finance charge assessed does not constitute interest (Boerner v. Colwell Co. (1978) 21 Cal.3d 37, 45-47), for literary convenience this opinion will not make these distinctions.

nificant on a short-term loan of a relatively small amount,[3] for larger loans of longer duration, the actuarial method results in a substantially larger refund to the consumer.

Plaintiff does not claim that defendant acted illegally by calculating the refund due him under the "Rule of 78's." Indeed, the Rees-Levering Motor Vehicles Sales and Finance Act (Civ. Code, § 2981 et seq.),[4] which governs the terms of conditional sale contracts for automobiles and mobile homes, states that the refund on prepayment may be determined according to the rule (Civ. Code, § 2982, subd. (e)(1)).[5] What plaintiff does contend is that the contract he signed was an adhesion contract and that the term "Rule of 78's" is ambiguous; thus the provision that the amount of rebate on prepayment is to be calculated in accordance with the rule is void.

There can be no doubt that the contract at bar is an adhesion contract, and defendant so concedes.[6] In a contract of adhesion, ambiguous terms will be interpreted against the stronger party and in a manner which would support the

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[3]For a 12-month loan of $1,200, subject to a finance charge of $96, the maximum difference between the rebate required by application of the 'Rule of 78's" and the actuarial method is 71 cents, if the loan is repaid after four months.

[4]Hereinafter called the Rees-Levering Act.

[5]The utilization of the "Rule of 78's" to calculate the rebate under the Rees-Levering Act is authorized where, as here, the finance charge is determined at the outset of the transaction. Although the act has been amended in numerous respects since plaintiff entered into the contract, this opinion will refer to the current version of the statute, unless the amendments have resulted in changes which are relevant to the issues before us.

[6]In Steven v. Fidelity & Casualty Co. (1962) 58 Cal.2d 862, 882, we defined such a contract as a "standardized contract prepared entirely by one party to the transaction for the acceptance of the other; such a contract, due to the disparity in bargaining power between the draftsman and the second party, must be accepted or rejected by the second party on a 'take it or leave it' basis, without opportunity for bargaining and under such conditions that the 'adherer' cannot obtain the desired product or service save by acquiescing in the form agreement."

reasonable expectations of the weaker party. (Gray v. Zurich Insurance Co. (1966) 64 Cal.2d 263, 270-271.)

Defendant urges that the term "Rule of 78's" is not ambiguous because it has a settled meaning. It is true that, unlike other contractual provisions which have been held to be ambiguous (*e.g.*, Estate of White (1970) 9 Cal.App.3d 194, 200; Atchison T. & S. F. Ry. Co. v. Brotherhood R. R. Trainmen (1964) 229 Cal.App.2d 607, 615), the phrase in issue unquestionably has an established meaning. It is equally true, however, that, as is well known to the members of the financial community, including defendant, the average consumer lacks the vaguest notion of what those words mean and that, therefore, the term conveys no information to him regarding the means by which a rebate will be calculated. Whether or not the use of a term which the drafter of the contract knows to be unintelligible to the weaker party invokes the law relating to adhesion contracts we need not reach because we conclude this court is prohibited by federal law from requiring that a lender explain the meaning of the words in question.

We turn, then, to a summary of the laws requiring disclosure of credit terms to consumers. The purpose of such enactments is to assure that a consumer will be in a position to "compare more readily the various credit terms available to him and avoid the uninformed use of credit." (See 15 U.S.C.A., § 1601 et seq.) These provisions are embodied by the federal government in the Truth in Lending Act (hereinafter TILA). TILA provides that state disclosure laws inconsistent with the act are not binding on a creditor. (15 U.S.C.A. § 1610, subd. (a).) In California, the disclosure laws appear in the Rees-Levering Act, and in the Unruh Act (Civ. Code, § 1801 et seq.), which regulates retail installment sales.

The TILA empowers the Federal Reserve Board (Board) to enact regulations to carry out its purposes (15 U.S.C.A., § 1604), and the Board has promulgated detailed rules in Regulation Z (12 C.F.R. Part 226) pursuant to this authorization. The Rees-Levering Act provides that any information required to be disclosed in a conditional sale contract subject thereto may be set forth in the terminology "required or permitted under Regulation Z." (Civ. Code, § 2982, subd. (g).)

Under Regulation Z, a creditor must identify the method of computing any unearned portion of the finance charge in the event of prepayment of an obligation. (12 C.F.R., § 226.8, subd. (b)(7).)[7] In an interpretation of this provision, the Board has determined that if a rebate is made according to the "Rule of 78's" a reference to the rule without explanation of its meaning or operation is sufficient, giving as its reason that an explanation of the rule involves "complex mathematical descriptions which generally cannot be condensed into simple accurate statements, and which if repeated at length on disclosure forms could detract from other important disclosures." (12 C.F.R., §226.818, subd. (c).)

A federal court has upheld the validity of these regulations. In Bone v. Hibernia Bank, (9th Cir. 1974) 493 F.2d 135, a borrower claimed that a lender violated the TILA by failing to explain the operation of the "Rule of 78's." The court acknowledged that the meaning of the rule "is known to virtually no credit consumers" (493 F.2d at p. 139) but held that the Board was empowered to decide that a lender

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[7]The Rees-Levering Act was amended in 1979 to provide that as of January 1, 1981, a contract subject to its terms must identify the method of calculating a rebate on repayment, and that a reference to the "Rule of 78's" constitutes sufficient identification. (Civ. Code, § 2982, subd. (a)13(A).)

should not be required to explain the operation of the rule, and that the Board's reasons for this determination were persuasive.

In reaching its conclusion, the court relied in part upon a statement by the vice chairman of the Board of Governors of the Federal Reserve Board that the Board was unable to find a simple way to explain the rule and that the alternative "would seem to require a lengthy and complicated mathematical statement which . . . would be . . . uninformative to the consumer, and would have the added disadvantage of further complicating the disclosure statement and detracting from other important disclosures." The court went on to say: "[I]t is precisely these kinds of policy decisions about the disclosure statement, requiring the weighing and balancing of the various available choices, that Congress entrusted to the Federal Reserve Board by granting it such broad powers. the conclusions thus reached by the Board are based upon its specialized experience and access to information, which is not likely to come to the attention of a particular judge in a given case." (493 F.2d at p. 140.) The principles stated in *Bone* have been followed in other federal cases. (See, *e.g.*, Gantt v. Com. Loan Co. (8th Cir. 1978) 573 F.2d 520, 524-526; but see Scott v. Liberty Finance Co. (D. Neb. 1974) 380 F.Supp. 475, 479.)

Plaintiff does not challenge the Board's authority to determine that an explanation of the rule is not required, nor does he explictly challenge the Board's reasons for this determination. Rather, he claims that the federal regulations set forth only a minimum standard, and that a state is free to require a definition of the rule under its laws relating to adhesion contracts. He recognizes that state laws inconsistent with the TILA are not binding on creditors (15 U.S.C.A., § 1610, subd. (a)), but relies upon a provision of Regulation Z to the effect that a creditor may supply

explanations in addition to those mandated by the regulation if the additional information does not "confuse the customer . . . or obscure, or detract attention from the information" which must be provided under Regulation Z. (12 C.F.R., § 226.6, subd. (c).)

Plaintiff all but concedes that a detailed mathematical explanation of the operation of the rule would confuse the consumer or obscure other disclosures required by the TILA. He claims, however, that a chart setting forth the amount of rebate due at various times of prepayment or an example of how the rule operates in a typical contract would convey the essential information without doing violence to the intent and purpose of the TILA.

Even if we were to agree that such an explanation would be helpful, we are not free to hold that it is required. The Board's rulings go further than the mere absence of a requirement that the creditor define the rule. The fact that the Board has exercised the authority given to it by Congress to determine that an explanation would be too complicated to be informative and would detract from other important disclosures mandated by Regulation Z constitutes a prohibition of a state-imposed requirement that the rule be defined by way of example or otherwise.

A recent case decided by the United States Supreme Court supports our conclusion. Ford Motor Credit Co. v. Milhollin (1980) 444 U.S. 555, involved the validity of the Board's interpretation of the TILA as not requiring a statement in the loan contract that the creditor has the right to accelerate payment of the entire debt upon the buyer's default. As in *Bone v. Hibernia Bank, supra*, 493 F.2d 135, the high court upheld the Board's discretion in making the ruling, using language which reiterates the broad sweep of the Board's

powers in interpreting the TILA[8] Of particular significance for the problem before us is the following language: "The concept of 'meaningful disclosure' that animates TILA . . . cannot be applied in the abstract. *Meaningful* disclosure does not mean *more* disclosure. Rather, it describes a balance between 'competing considerations of complete disclosure . . . and the need to avoid . . . [informational overload].' . . . And striking the appropriate balance is an empirical process that entails investigation into consumer

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[8]The court stated:

"It is commonplace that courts will further legislative goals by filling the interstitial silences within a statute or a regulation. Because legislators cannot foresee all enventualities, judges must decide unanticipated cases by extrapolating from related statutes or administrative provisions. But legislative silence is not always the result of a lack of prescience; it may instead betoken permission or, perhaps, considered abstention from regulation. In that event, judges are not accredited to supersede Congress or the appropriate agency by embellishing upon the regulatory scheme. Accordingly, caution must temper judicial creativity in the face of legislative or regulatory silence.

"At the very least, that caution requires attentiveness to the views of the administrative entity appointed to apply and enforce a statute. And deference is especially appropriate in the process of interpreting the Truth in Lending Act and Regulation Z. Unless demonstrably irrational, Federal Reserve Board staff opinions construing the Act or Regulation should be dispositive for several reasons.

". . . [T]raditional acquiescense in administrative expertise is particularly apt under TILA, because the Federal Reserve Board has played a pivotal role in 'setting [the statutory] machinery in motion. . . .' [Citation omitted.] . . . Congress delegated broad administrative lawmaking power to the Federal Reserve Board when it framed TILA. The Act is best construed by those who gave it substance in promulgating regulations thereunder. . . . Moreover, language in the legislative history evinces a decided preference for resolving interpretive issues by uniform administrative decision, rather than piecemeal through litigation. . . . Courts should honor that congressional choice. Thus, while not abdicating their ultimate judicial responsibility to determine the law, . . . judges ought to refrain from substituting their own interstitial lawmaking for that of the Federal Reserve, so long as the latter's lawmaking is not irrational.

"Finally, wholly apart from jurisprudential considerations or congressional intent, deference to the Federal Reserve is compelled by necessity; a court that tries to chart a true course to the Act's purpose embarks upon a voyage without a compass when it disregards the agency's views." (444 U.S. at pp. 565-568.0

psychology and that presupposes broad experience with credit practices. Administrative agencies are simply better suited than courts to engage in such a process." (444 U.S. at pp. 568-569.)

The Board's determination that if the meaning of the term "Rule of 78's" were defined in conditional sale contracts the result would confuse consumers and detract from other important disclosures is an attempt by the Board to strike the balance between "competing considerations of complete disclosure . . . and the need to avoid . . . ['informational overload]' "[9] and state law which would require explanation of the rule would disturb that balance.[10]

Our conclusion is further buttressed by an unofficial letter interpretation of Regulation Z by the Board, issued at defendant's request after the commencement of this litigation. The letter states that in light of the Board's conclusion that the operation of the "Rule of 78's" cannot be explained in a simple manner and that an attempt at an explanation would detract from other important disclosures required by the regulation, "it is the staff's opinion that a state law (whether statutory or judicially imposed) requiring disclosure of the meaning and implication of the Rule of 78's formula would be inconsistent with Regulation Z. . . ."

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[9]Congress appears to be heading in the direction of fewer, more simplified disclosures. After a nationwide consumer credit survey revealed that disclosure statements were too complicated, Congress recently amended the TILA to provide that as of 1982, a lender need only indicate whether or not the consumer is entitled to a rebate of any finance charge upon prepayment. (Pub.L.No. 96-221, §§ 614, subd. (a), 625, subd. (a); 94 Stat. 132 (Mar. 31, 1980).)

[10]A recent report of the Senate Banking, Housing and Urban Affairs Committee recommends that state legislatures prohibit the utilization of the "Rule of 78's" for long term transactions. The committee also recommends the establishment of a National Consumer Usury Commission to consider whether Congress should prohibit use of the rule. (Sen. Rep. No. 96-923, 2nd Sess., p. 11 (1980).)

Plaintiff argues that Regulation Z permits disclosures pursuant to state requirements in addition to and inconsistent with those set forth in the regulation, provided that the form of such disclosures comports with the provisions of section 226.6, subdivision (c) of Regulation Z. Subdivision (c) states that a creditor may, at his option, provide additional information or explanations to a consumer if the additional matter does not mislead the customer or obscure or detract from the disclosures required by Regulation Z, and provided also that these additional disclosures are made on a separate paper or are clearly identified as state disclosures and appear below the disclosures required by the regulation.

Plaintiff's assertion is without merit for two reasons. First, both the regulation and the unofficial board interpretation referred to make it clear that a creditor may *elect* to make explanations provided for by state law which are inconsistent with Regulation Z, but may not be required to do so.[11] Second, the Board has determined that explanation of the rule would mislead the customer and detract from other important information which Regulation Z requires to be disclosed in the contract; therefore, an explanation of the rule is prohibited by the terms of subdivision (c) even if the creditor complies with the format specified therein.[12]

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[11]The letter from the Board states, "It is the staff's opinion that the making of inconsistent state disclosures in accordance with § 226.6(c) is done at the creditor's option; a creditor could elect not to make the state-required disclosures."

[12]Mason v. General Finance Corp. of Virginia (1976) 542 F.2d 1226, relied upon by plaintiff, is distinguishable. It was there held that a state disclosure law which required the use of terminology different than specified by TILA was inconsistent with the federal enactment, but that the state-imposed terminology could appear in the contract provided that it was not intermingled with the information required by Regulation Z and complied with the requirements of form set forth in subdivision (c) of section 226.6. Unlike the present case, *Mason* did not involve the question whether an inconsistent state disclosure requirement was mandatory upon the creditor since the issue there was not the creditor's failure to disclose but an improper form of disclosure. Second, *Mason* did not deal with the creditor's failure to explain a term in the contract which the consumer did not comprehend and a determination by the Board that an explanation would confuse the consumer.

Plaintiff next asserts that a requirement imposed by the state that a conditional sale contract warn the consumer of the consequences of the application of the rule would not violate federal law and would alert consumers to the disadvantages inherent in the operation of the rule.

It is probably ture that a statement in the nature of a warning to the consumer is not contrary to federal law. (See 12 C.F.R. § 226.604, subd. (b).)[13] However, we cannot conclude that a court may impose a requirement for such a warning under the law of adhesion contracts. The warning would not resolve any ambiguity in the meaning of the term "Rule of 78's" and thus would not cure the only contract defect upon which plaintiff relies.[14]

We conclude, therefore, that the trial court did not err in sustaining the demurrer. Nevertheless, since both parties have discussed at great length whether the rule is fair to consumers and whether its use is justified because of the manifest benefits to the creditor, we discuss their assertions in this regard.

Although a simple explanation of the operation of the "Rule of 78's," if one could be devised, or a warning of

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[13]The section provides: "Whether State laws are inconsistent with Regulation Z necessarily depends on the nature of the State laws. Section 226.6(b)(1) provides that State law is inconsistent to the extent that it 'requires a creditor to make disclosures different from the requirements of this part with respect to form, content, terminology, or time of delivery.' This refers to disclosures of the kinds of information covered by Regulation Z, and not to other or collateral information such as a statement telling the customer that he should read the contract carefully, or that there should be no blanks in the contract. . . ."

[14]An additional principle of the law of adhesion contracts is that even a term clearly stated may be unenforceable if it is so unconscionable that its enforcement would be contrary to public policy. (See, e.g., Tunkl v. Regents of University of California (1963) 60 Cal.2d 92, 99-101.) But, although plaintiff asserts that the rule is unfair to consumers, an argument which we shall discuss in detail, *infra*, he does not seek its invalidation for that reason; his complaint focuses upon the absence of an explanation of the operation of the rule.

its disadvantages, could be of some assistance to consumers,[15] the more fundamental question is whether utilization of the rule should be permitted at all.

In considering fairness to the consumer, we begin with the observation that the rule applies not only to a borrower who repays a loan in full prior to maturity and liquidates the debt, but also to prepayment because of refinancing or consolidation of debts. In the latter event, the rule is applied to the renewed debt as part of the amount financed. A very substantial number of loans are refinanced or consolidated, perhaps as high as 70% or 80% in some types of loans.[16] According to defendant, 43 states authorize calculation of a prepayment rebate by the "Rule of 78's" but most of them limit the term or size of the loan to which the rule may be applied.[17] One popular writer on financial affairs declares that the Federal Trade Commission estimates the exaction of the finance charge under the rule costs the consumer $112 million a year in "overcharges" although some estimates place the figure more conservatively at between $50 million and $100 million a year. (Porter, *Your Money, Learning About the "Rule of 78's"* San Francisco Chronical (April 18, 1980) p. 34, col. 1.) Thus, it is clear that the rule is applied to a vast number of consumer transactions

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[15]There is some question whether even a simplified explanation would be meaningful to a consumer without a reference to the actuarial method of computation and an explanation of its advantages over the "Rule of 78's" so that the consumer would have some means of comparison. There is considerable doubt whether the complexity of such an explanation would not outweigh its benefits, even if a state were free to require an explanation.

[16]Hunt, *Hidden Penalty in the Rule of 78*, (1975) 55 Boston L.Rev. 331, 333 (hereafter *Hunt*).

[17]As we shall see, recent amendments to the Rees-Levering Act and the Unruh Act have limited the term of a loan to which the rule may be applied.

and that the cost to the consumer from its utilization is enormous.

Defendant, in support of its argument that the calculation of a rebate by the "Rule of 78's" does not yield significantly different results from the actuarial method, employs a small loan ($1,200) of short duration (one year) to demonstrate that the difference between the two methods amounts to only 71 cents if the loan is repaid in the fourth month. (See fn. 3, *ante* at p. 5.) However, if the amount of the loan or its term is increased, use of the rule can result in a much smaller refund than if the actuarial method were applied. *Hunt*, in a revealing exposition of the manner in which the rule operates, offers the following examples: a $15,000 mobile home financed over a period of 12 years at the rate of $9 per $100 in interest, and repaid at the end of the 52nd month, requires the lender to rebate $1,157 more if the amount of the rebate is calculated by the actuarial method than by the "Rule of 78's." Using the loan terms, a borrower who prepays the loan in the first three months of its term will pay over 17 percent interest expressed as the annual percentage rate [the only figure in the contract which discloses to the borrower how much credit costs him (Mason v. General Finance Corp., supra, 542 F.2d 1226, 1233)] which is more than three percent over the rate actually disclosed in the contract. Even for a loan of a shorter term (48 months) and a far lesser amount ($5,000), the buyer receives $54 less as a rebate under the rule than if the actuarial method were utilized. (*Hunt, op cit. supra*, at pp. 347, 361.)

Other commentators have remarked upon the unfair effect of the rule on consumers. (See, e.g., Comment, *Consumer Protection: Truth-in-Lending Disclosure of the Rule of 78ths*, 59 Iowa L.Rev. 164, 175-176; *Legislative Regulation*

of Retail Installment Financing, 7 U.C.L.A. L.Rev. 618, 685-686.)

Defendant insists that the rule is fair to borrowers and its use justified by the business needs of the creditor. First, it asserts, it is easier to calculate a rebate by the rule than by the actuarial method. Whatever may have been true in the late 19th and early 20th centuries, when businessmen were required to calculate rebates manually, the advent of computers has eliminated this basis as support for use of the rule; undoubtedly, in the very large majority of credit transactions today the lender has a mechanical device available to readily determine the rebate. Even for the relatively few creditors who do not have access to such a machine, the use of pre-calculated, published tables of refunds payable under the actuarial method would substantially resolve the problem. (See, *Hunt, op cit. supra*, at p. 360.)

The second justification advanced by defendant is that the rule permits creditors to recover their transaction costs, and unless such costs are recovered, the borrower who does not prepay his loan in effect subsidizes the borrower who does. These transaction costs include those associated with extending credit in the first instance, such as the expense of advertising, depreciation, insurance, and other overhead expenses, the cost of carrying the credit after it has been extended, the expenses incurred in connection with bad debts, and collection and litigation expenses for delinquent loans. Defendant urges that these charges are spread over the term of the obligation upon the assumption that all payments will be made over the originally agreed-upon term of the contract, and that if the obligation is prepaid, the creditor does not recover them fully.

This problem may be resolved by requiring the borrower to pay a minimum finance charge for each transaction to reimburse the creditor for such costs. Furthermore, the

charge to the debtor by application of the rule bears no relationship to the costs involved in the processing and collection of his particular loan. Thus, a borrower who has faithfully made installment payments on time and who prepays the loan early in the term in fact decreases the transaction costs to a lender attributable to his loan, but he is in effect penalized by being compelled to pay a charge to assure that the lender recoups its investment from debtors who are less conscientious. In these respects, the borrower who pays his debt early may, in effect, subsidize those who do not pay at all. (Cf. Bondanza v. Peninsula Hospital & Medical Center (1979) 23 Cal.3d 260, 268-269; Garrett v. Coast & Southern Fed. Sav. & Loan Assn. (1973) 9 Cal.3d 731, 741.)[18]

Defendant asserts in addition that the use of the rule assures the creditor that he will receive the benefit of his bargain. Prepayment results in placing the creditor at the "risk of the market" in that he may not be able to obtain the same rate of return on new extensions of credit if interest rates are declining or the demand for credit is decreased, and he is put to the expense of seeking new investment opportunities and will incur additional transaction costs for such new investments. As to these last two items, they are included within the transaction costs referred to above. In the last few years the dramatic increase in the interest rate renders it unlikely that the creditor will suffer a loss from prepayment and reinvestment. The presumption that such a loss will occur and the automatic penalization of the borrower based upon such an assumption appears unsupportable.

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[18]In *Bondanza*, we held in view of the provisions of section 1671, subdivision (d), of the Civil Code that it was unlawful to impose upon a debtor a collection charge which bore no relationship to the actual cost of collection.

Another important factor in considering the validity of defendant's arguments is that neither the necessity for the creditor to recoup transaction costs nor to afford him the benefit of his bargain can justify application of the "Rule of 78's" to the vast number of loans made to refinance or consolidate debts. In the case of such loans, the unamortized transaction costs are carried over into the new debt, and the creditor is obviously not put at the "risk of the market" since the new loan is extended at the same time the old loan is prepaid,. The manifest absence of any justification for applying the rule to such transactions has led *Hunt* to suggest that is the rule is retained at all it should only be applied to the complete retirement of a debt on prepayment. (*Hunt, op cit. supra*, at p. 358.)

Finally, defendant urges that the use of the rule to compute rebates is not unfair to the consumer because it yields results comparable to the actuarial method as utilized to compute the interest charge on mortgages of real property. Defendant's assertion is based on the traditional real estate financing transaction, in which the lender may charge a prepayment penalty (Civ. Code, §2954.9) as well as a loan origination fee. When the penalty and the fee are added together, they may yield to the lender an amount comparable to the sum he would receive by application of the rule. We suggest this reasoning illustrates the shortcomings of the "Rule of 78's." Defendant admits that prepayment penalties are prohibited by statute for determining rebates under retail installment contracts. (Civ. Code, §2982, subd. (e)(1).) While we recognize that the Board has determined that calculation of the rebate by the rule does not amount to a "prepayment penalty," as defined in Regulation Z (12 C.F.R., §226.818, subd. (b)), nevertheless the smaller refund to the consumer and the concommitant greater profit to the lender under the rule serves, in defendant's own words

"as an alternate means by which . . . [it] can recoup the losses caused by prepayment of the contract." Thus, while application of the rule technically or semantically may not be termed a "penalty" in view of the Board's interpretation, it serves as a substitute for the prepayment penalty prohibited by statute.

In sum, the "Rule of 78's" is a hidden charge the operation of which is neither revealed to nor understood by the borrower, and it is a charge burdensome to the consumer and unjustified by the economic needs of the lender. Its adoption as the prevailing rule in this state is, of course, a legislative decision involving the weighing of policy matters as seen by legislators. Thus we would not be free to substitute our own views for those of the Legislature regarding the desirability of the rule even if plaintiff had sought a determination that it is invalid as a measure of the rebate because it is unfair to the consumer. The common law, which petitioner urges us to apply, is superseded when the Legislature acts. (People v. Hickman (1928) 204 Cal. 470, 479; Lowman v. Stafford (1964) 226 Cal.App.2d 31, 39.)

The Legislature has considered the rebate due a buyer on prepayment, the "Rule of 78's," and the manner of its disclosure a number of times in recent years. (Rees-Levering Act: Stats. 1961, ch. 1626, §4, pp. 3534, 3537; Stats. 1970, ch. 1003, §1, pp. 1800, 1803; Unruh Act: Stats. 1969, ch. 625, pp. 1264, 1266; Stats 1970, ch. 546, §14, pp. 1040, 1043-1044; Stats. 1971, ch. 1061, §1, pp. 2022, 2023.)[19] In 1979, it enacted several measures to alleviate the harsh-

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[19]The 1969 amendment to the Unruh Act required the lender to "explain" the method for computing the rebate on prepayment. However, this requirement was repealed the following year, when the statute was amended to provide that a reference to the rule was sufficient identification of the method of computing the rebate.

ness of the rule in certain transactions. Beginning in 1983, Rees-Levering contracts calling for payment in more than 62 months may not utilize the rule to calculate the amount of rebate due a buyer on prepayment. (Stats. 1979, ch. 805, §19, p. 2880.) As of January 1, 1981, the contract must include the following statement: "Because the refund [on prepayment] will be figured by the rule of 78's, the time when you prepay may affect the ultimate cost of credit under this agreement." (Civ. Code, §2982, subd. (a)(14)(A).)[20] Thus it is clear that the Legislature is aware of the issue surrounding the "Rule of 78's" and has taken such action as it deems appropriate. We would abuse judicial authority if we were to embellish legislative requirements.

The judgment should be affirmed.

MOSK, *J.*

WE CONCUR:

BIRD, *C.J.*
TOBRINER, *J.*
CLARK, *J.*
RICHARDSON, *J.*
NEWMAN, *J.*

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[20]Similar restrictions are imposed with regard to installment sale contracts which come under the Unruh Act. (Civ. Code, §1799.8, subd. (b); 1803.2, subd. (c).)

State of California, County of Kern, ss.

I, David Griffin, depose and say that I am an attorney in the office of Young, Wooldridge, Paulden, Self, Farr & Hugie, attorney of record for Loyd Drennan, the Petitioner herein, and that on April 8, 1981, pursuant to Rule 33, Rules of the Supreme Court, I served the attached application for extension of time on each of the parties required to be served herein, as follows:

Mr. William M. Burke,
SHEPPARD, MULLIN, RICHTER & HAMPTON
Attorneys at Law
4000 MacArthur Boulevard, Suite 500
Newport Beach, CA. 92660

All parties required to be served have been served.

/s/ David Griffin
DAVID GRIFFIN

Subscribed and sworn to before
me on April 8, 1981.

/s/ Susan Tull
NOTARY PUBLIC

[Notarized]

APPENDIX B.

"(7) Identification of the *method of computing any unearned portion of the finance charge* in the event of prepayment in full of an obligation which includes precomputed finance charges and a statement of the amount or method of computation of any charge that may be deducted from the amount of any rebate of such unearned finance charge that will be credited to an obligation or refunded to the customer. If the credit contract does not provide for any rebate of unearned finance charges upon prepayment in full, this fact shall be disclosed."

12 C.F.R. §226.8(b)(7)